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SUBJECT: ROMANIA: BY TAPPING ON THE BRAKES, THE CENTRAL BANK KEEPS
THE FINANCIAL CRISIS UNDER CONTROL

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¶1. (SBU) Summary. Several factors particular to the Romanian economy have reduced the local impact of the global financial crisis. Overall, Romania's financial and banking system has sufficient liquidity and is not expected to experience any negative short-term repercussions from the current crisis. However, Romania's macro-economic picture is fragile, largely due to poor government budget discipline at a particularly sensitive time. In all likelihood, Romania will experience a slow down in economic growth rates in the medium term. Of continuing concern is a future depreciation of the Leu against the Euro, which would have negative implications for inflation and future credit growth, even as it positively affects the current account deficit. According to the Romanian Central Bank (BNR) the current high rates on overnight inter-bank loans are chiefly a result of an unsuccessful speculative attack against the Leu. End summary.

¶2. (SBU) The DCM and EconOffs met with Shamir Khaliq, the President of Citibank Romania, on October 17. Khaliq mentioned that he had just returned from an emergency conference involving the President of Romania, the Central Bank, and the commercial banking community. He indicated that his perception, reinforced by the emergency meeting, is that sufficient liquidity exists in Romania to weather the global financial crisis. Noting that he found the latest report issued by Goldman Sachs on Romania unfair, he laid out some of the differences present in the Romanian economy, which would mitigate the fallout from the crisis. As opposed to Hungary, which was highlighted in the same report, Romania has very low debt to GDP ratios, low public debt to total debt ratios, high loan provisioning requirements for banks, and high minimum reserves requirements. On the liquidity question, he pointed out that local banks are required to hold minimum reserves equivalent to 20 percent of their local currency balance sheet, and 40 percent for books denominated in foreign currencies. This means that 9 billion Euros out of a 60 billion Euro banking market are immediately available to the BNR if it ever has to inject emergency liquidity into the system. These reserves are almost three times larger than the entire overnight interbank market. Acknowledging the very high interest rates on the overnight market, he said that the small overall size of this market made it possible for the BNR to act as a counterparty, if it so chooses, to transactions if the market were to completely shut down.

¶3. (SBU) At the same time, foreign speculators tested the BNR's resolve and began making large bets against the Leu last week, expecting the BNR to abandon a defense of the currency. However, the BNR cut off the attack by doing two things, temporarily selling Euros to prop up the Leu, and then declining to provide extra liquidity to the overnight market on October 17 as the speculators

scrambled to settle their positions. While this action temporarily raised interest rates on overnight loans to 80 percent, and while reverberations are still being felt in the commercial market this week, the BNR is unrepentant, with Governor Isarescu announcing to the press on the 20th: "Those who made mistakes in their betting have received a lesson. Technically, all of their swaps couldn't be re-financed, because the Leu had been pulled out of the market. It is not glorious for a large bank to be unable to close its position."

¶4. (SBU) The forex rate has remained volatile this week, with the Leu reversing its recent depreciation and recovering five percent of its value, perhaps as a result of the BNR's intervention. This volatility presents concerns for individuals with large foreign currency loans. In an October 10th meeting at the IMF, the regional representative for Romania and Bulgaria, Juan Ferndanez-Ansola, highlighted foreign currency lending as the major cause for concern in the local environment. He pointed out that consumers earning local currency wages have borrowed 14 billion Euros from banks in Romania. So far this risk has been mitigated by rapidly rising wages. As the growth rate begins its expected decleration next year, the risk of defaults on these loans rises. This, coupled with the recently implemented stricter provisioning requirements on new foreign currency lending, should decrease demand and encourage individuals to move to Leu-denominated fixed interest loans. Unfortunately, the high overnight market rates are having the opposite short-term effect, with interest rates on some variable loans shooting up to 18 percent this week.

¶5. (SBU) Despite believing that the credit market will shrink in the next year, the IMF is currently forecasting a 4.8% GDP growth rate for Romania in 2009. While the local IMF has traditionally held a bearish attitude about the Romanian economy, Fernandez-Ansola

believes that the global financial crisis will only slow down investment and marginally increase unemployment, but not stop growth completely (Comment: Given the current upward pressure on wages, an uptick in unemployment would be welcomed in some quarters. End Comment.) A bigger concern for the IMF is the GOR's lack of fiscal discipline in an election year. Highlighting the 50 percent raise recently approved for teachers (ref A), Fernandez-Ansola remarked that the GOR will need a net six billion Euros to meet obligations before the end of this year, an amount which, especially given the current situation, is impossible to finance on the international market. The MEF is instead locked into the domestic market, and correspondingly high interest rates, simply to meet existing obligations, which will make future spending still more difficult.

¶4. (SBU) Another cushion for the Romanian market is that local mortgage loans are typically extended for no more than 40 to 70 percent of the value of the property, most of which are owner-occupied. The high individual equity, and relative novelty of mortgage lending, means that foreclosures are still a rarity in Romania, as the owners carrying loans are able to sell their substantial equity stake in their homes and pay off the mortgage in cases of financial distress. It is true that many of these mortgages are denominated in Euros, which carry lower interest rates, but bear a substantial exchange rate risk. A rapidly depreciating Leu can be a double whammy for households, raising the cost of the loan, while at the same time inflating the prices for basic imported goods. One negative aspect of EU accession for Romanian households is that imported food and higher quality consumer goods have driven many local producers out of business. Accordingly an exchange rate swing in Romania would have an immediate and disproportionate impact on household consumption.

¶6. (SBU) Comment. Perversely, a reduction in the availability of credit and a cooling of the global economy is precisely what Romania needs in order to put itself on a more stable long-term growth track. Instead of having a negative impact, slowing credit growth is precisely the tap on the brakes that is needed to keep the Romanian economy on its current growth trajectory. Credit penetration is still low compared to the more developed EU economies, with the average Romanian having little exposure to financial markets and consumer debt. Some individuals and firms,

especially those overextended in foreign currencies, will be impacted and certain sectors will slow. However, economic growth in Romania is broadly based and reflects, more than anything else, a belated catch-up with the rest of the EU. The long-term problems of insufficient investment in infrastructure, education, and healthcare, are very different from a short-term financial panic in global markets. Rather, the crisis has hit precisely at the time that Romania has been feeling the negative inflationary effects of an expected eight percent annual GDP growth rate, a rate which the GOR has been understandably unwilling to reduce in an election year. A forced reduction in the availability of credit will limit the impact of the Romanian Parliament's increasingly irresponsible attitude towards fiscal discipline, as well as Parliament's scope for future "presents" to the Romanian voter. End comment.

Taubman